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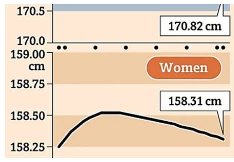

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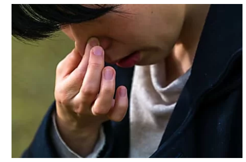
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An employee using a smartphone demonstrates a bitcoin ATM at the Coin Trader bitcoin retail store at the Nakano Broadway complex in Tokyo's Nakano Ward on Wednesday. | BLOOMBERG

BUSINESS

Cryptocurrencies threaten central banks' control over money supply — and officials study using their technology

1/3

BY ENDA CURRAN, PIOTR SKOLIMOWSKI AND CRAIG TORRES
BLOOMBERG

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HONG, KONG/FRANKFURT/WASHINGTON – The boom in cryptocurrencies and their underlying technology is becoming too big for central banks, long the guardian of official money, to ignore.

Until recently, officials at major central banks were happy to watch as pioneers in the field progressed by trial and error, safe in the knowledge that cryptocurrencies were dwarfed by the roughly $5 trillion circulating daily in conventional currency markets.

But now, as officials turn an eye toward the increasingly pervasive technology, the risk is that they are reacting too late to both the pitfalls and the opportunities presented by digital coinage.

"Central banks cannot afford to treat cybercurrencies as toys to play with in a sandbox," said Andrew Sheng, chief adviser to the China Banking Regulatory Commission and a distinguished fellow of the Asia Global Institute at the University of Hong Kong. "It is time to realize that they are the real barbarians at the gate."

The cryptocurrency Exio Coin will start a round of fundraising on Thursday, with its founders claiming a unique distinction: the first to be endorsed by a sovereign nation. The identity of the government backer won't be revealed until October, and the claim of support is currently unverifiable. According to co-founder Sunny Johnson, though, the supporter is one of "the world's richest countries" on a per capita basis.

Bitcoin — the largest and best-known digital currency — and its peers pose a threat to the established money system by effectively circumventing it. Money as we know it depends on the authority of the state for credibility, with central banks typically managing its price and/or quantity. Cryptocurrencies skirt all that and instead rely on their supposedly unhackable technology to guarantee value.

China's lead

If central banks don't get a handle on bitcoin and their ilk, and more people adopt them, the banks could see an erosion of their control over the money supply. The solution may be in the old adage "If you can't beat them, join them."

The People's Bank of China has done trial runs of its prototype cryptocurrency, taking it a step closer to being the first major central bank to issue digital money.

The Bank of Japan and the European Central Bank have launched a joint research project that studies the possible use of distributed ledgers — the technology that underpins cryptocurrencies — for market infrastructure.

The Dutch central bank has created its own cryptocurrency — for internal circulation only — to better understand how it works.

And Ben Bernanke, the former chairman of the U.S. Federal Reserve, who has said digital currencies show "long term promise," will be the keynote speaker at an October conference on banking and blockchain technology hosted by Ripple, the startup behind the fourth-largest digital currency.

Russia, too, has shown interest in Ethereum, the second-largest digital currency, with the central bank deploying a pilot blockchain program.

In the U.S., banks and regulators are studying distributed ledger technology, which uses decentralized shared databases. Fed officials have made a couple of formal speeches on the topic in the past 12 months but have voiced reservations about digital currencies.

Policy issues

Fed Gov. Jerome Powell said in March there are “significant policy issues” that need further study, including vulnerability to cyber-attack, privacy issues and counterfeiting. He also cautioned that a central bank’s digital currency could stifle innovations to improve the existing payment system.

At the same time, central bankers are obviously wary of the risks posed by alternative currencies — including financial instability and fraud. For example, the Tokyo-based Mt. Gox exchange collapsed spectacularly in 2014 after disclosing that it had lost hundreds of millions of dollars’ worth of bitcoin.

But for all their theoretical tinkering, guardians of official money have largely stood by as digital currencies have taken off. The explosion in initial coin offerings (ICOs) is evidence. Investors have poured hundreds of millions of dollars into the digital currency market this year alone.

The dollar value of the 20 biggest cryptocurrencies is around $150 billion, according to data from Coinmarketcap.com (http://Coinmarketcap.com). Bitcoin itself has soared more than 380 percent this year and hit a record — but it is prone to wild swings, like a 50 percent slump at the end of 2013.

“At a global level, there is an urgent need for regulatory clarity given the growth of the market,” said Daniel Heller, a visiting fellow at the Washington-based Peterson Institute for International Economics and previously head of financial stability at the Swiss National Bank.

Self-interest

Rather than trying to regulate virtual currencies, central banks are mainly warning of risks and attempting to garner some advantages from distributed-ledger technology for their own purposes, like upgrading payment systems.

Carl-Ludwig Thiele, a board member of Germany’s Bundesbank, has described bitcoin as a “niche phenomenon” but blockchain as far more interesting if it can be adapted for use by central banks.

In July, National Bank of Austria President Ewald Nowotny said he is open to new technologies but doesn’t believe they will lead to a new currency, and said that dealing in bitcoin is effectively “gambling.”

There could also be a monetary policy aspect to consider. ECB Governing Council member Jan Smets said in December that a central bank’s digital currency could give policymakers more leeway when interest rates are negative. Policymakers have long been concerned that if they cut rates too low, people will simply hoard cash. The ECB’s deposit rate is currently minus 0.4 percent.

Other central banks see the uses of distributed-ledger technology but worry about the abuses that virtual money can be put to outside the official system — such as money laundering and the sale of illegal goods.

That is not to mention the risk that virtual currencies could pose to the rest of the financial system if the bubble were to pop.

‘Great promise’

Bank of England Gov. Mark Carney — who has said blockchain technology shows “great promise” — also warned regulators this year to keep on top of developments in financial technology if they want to avoid a 2008-style crisis.

While Mt. Gox cast a shadow over bitcoin in Japan, it now has many supporters in the world’s third-biggest economy. The Diet passed a law in April making it a legal method of payment. Japan’s largest banks have invested in bitcoin exchanges, and small-cap stocks linked to the cryptocurrency or its underlying technology have rallied this year as it begins to win favor with some retailers.

With the Financial Services Agency responsible for regulating bitcoin, the BOJ remains focused on studying its distributed-ledger technology.

Not ready yet

“Central banks are not yet ready for regulating digital currencies,” said Xiao Geng, a professor of finance and public policy at the University of Hong Kong. “But they have to in the future, since unregulated digital currencies are prone to crime and Ponzi-type speculation.”

To be sure, the attraction of virtual currencies for many remains speculation, rather than for households or companies buying and selling goods.

“It is a fad that will die down, and it will be used by less than 1 percent of consumers and accepted by even fewer merchants,” said Sumit Agarwal of Georgetown University, who was previously a senior financial economist at the Federal Reserve Bank of Chicago. “Even if we can make the digital currency safe, it has many hurdles.”

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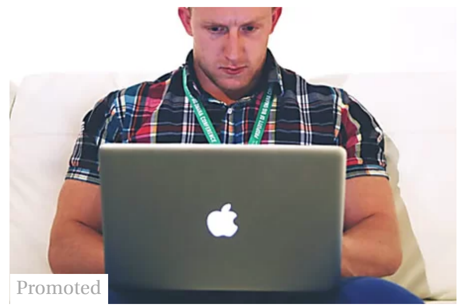

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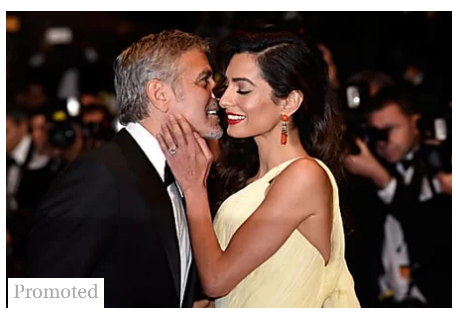

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